# NETWORK GENERAL

1992 ANNUAL REPORT

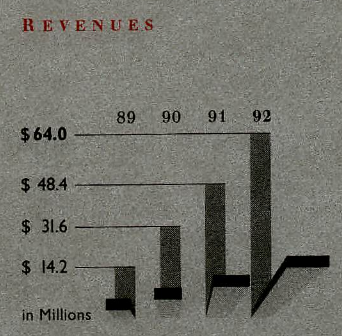
## ABOUT THE COMPANY

Network General Corporation is a leading supplier of software-based monitoring and analysis products that help troubleshoot and maintain local area networks. The Company, which also offers products for use in wide area networks, has built its reputation on the award-winning Sniffer family of network analysis products. This product family includes the Distributed Sniffer System, Expert Sniffer Network Analyzer, and Watchdog Network Monitor. A broad range of professional services, such as consulting and training, complement these products. — As specialists in the business of network analysis, Network General is well positioned to participate in the market for networking products. Because the Company provides tools for networks of all major types, it is able to serve the needs of a wide variety of organizations.

### Financial Highlights

(in millions, except per share amounts)

| | 1992 | 1991 | 1990 | 1989 |
|---|---|---|---|---|
| Revenues | **$ 64.0** | $ 48.4 | $ 31.6 | $ 14.2 |
| Net Income | **$ 9.0** | $ 7.9 | $ 5.9 | $ 2.7 |
| EPS | **$ .56** | $ .51 | $ .41 | $ .25 |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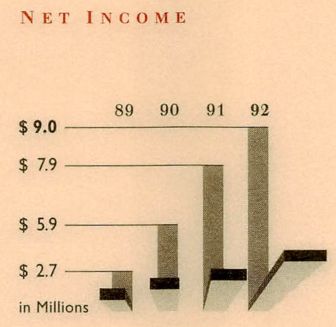
in Millions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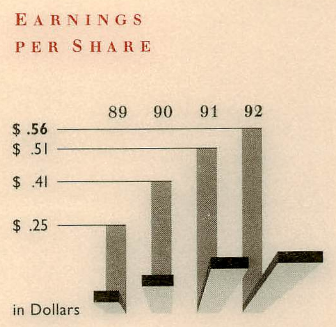
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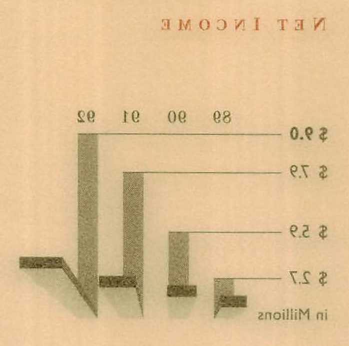
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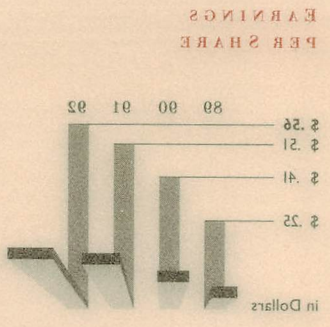
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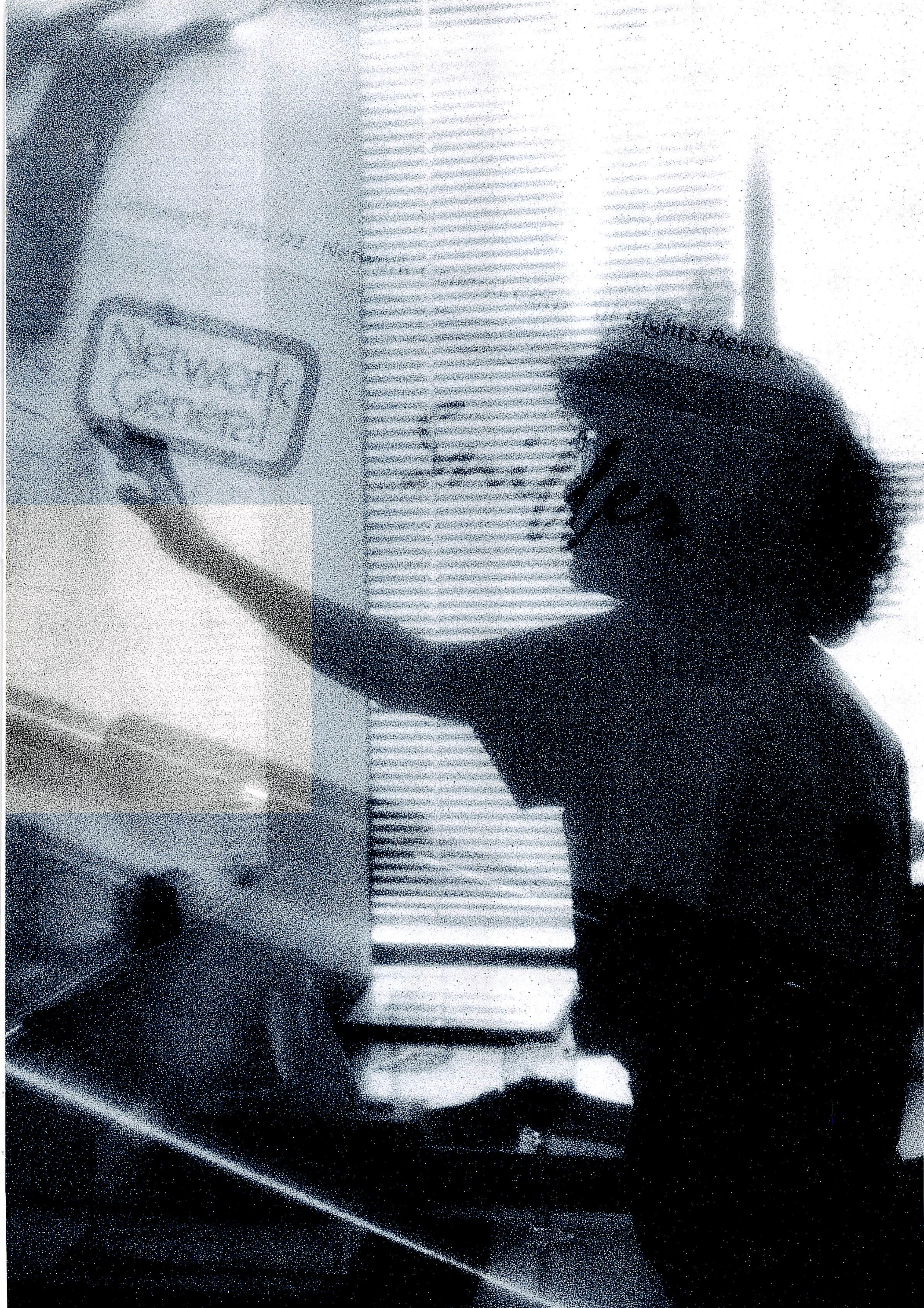

Network Centre

# DEAR SHAREHOLDERS

Fiscal 1992 was another record-setting year for Network General. The Company successfully completed a major acquisition, expanded its product offerings, and established a direct domestic sales force. These accomplishments advanced our ongoing commitment to provide network managers with valuable tools and systems for solving and avoiding costly, complex network problems.

## Strong Financial Results

Despite a weak economy, we are pleased to report that fiscal 1992 was our sixth consecutive year of double-digit growth in both revenues and profits. Our revenues increased 32%, to $63,985,000, up from $48,438,000 in fiscal 1991. Net income rose 14%, to $8,987,000 (or $0.56 per share), from $7,850,000 (or $0.51 per share) in the previous year. Full year earnings were reduced by approximately $0.07 per share due to expenses associated with the acquisition of Progressive Computing, Incorporated in the second quarter of fiscal 1992. The Company ended the fiscal year with approximately $35,422,000 in cash, cash equivalents, and short term investments. On April 6, 1992, we completed a public offering of 2,500,000 shares of common stock at a price of $19.50 per share, and the Company received net proceeds of approximately $46,000,000.

## Network General's Focus

We continue to pursue the same vision we had in 1986 when we pioneered seven-layer protocol analysis for local area networks (LANs): We help users manage network complexity, and by doing so, we increase

their ability to harness the power of their computer networks. Although Network General has expanded beyond LANs into wide area networks (WANs) and telecommunications, we hold to the goal of helping our customers cope with complex network problems. By remaining tightly focused on solving network problems, we can provide the greatest value to our customers and continue our efforts to develop valuable network analysis products.

## Moving Into Enterprise-Wide Networks

While the growth of networking in the eighties was predicted for at least ten years, few people foresaw the growth of enterprise-wide networks in the early nineties. These large, geographically dispersed, interconnected LANs and WANs will constitute the backbone of corporate computing well into the next century, and present a unique opportunity for Network General. Even a single LAN is difficult to manage, but a series of interconnected, mission-critical networks is a constant battle.

To address this opportunity, the Company has expanded its scope. In August, 1991, Network General acquired Progressive Computing, Inc., a producer of PC-based WAN diagnostic tools, located in Oak Brook, Illinois. Progressive's expertise in areas such as medium and highspeed WAN testing and analysis, complements our expertise in the LAN world. We believe that our combined strengths and resources will enhance our ability to develop network analysis and monitoring tools to serve the needs of the growing LAN interconnect market for enterprise-wide network management.


### Expanding From Tools To Systems

The portable Sniffer Network Analyzer has been Network General's flagship product for the last six years and continues to be our leading revenue producer. We believe that standalone tools, such as the Sniffer Network Analyzer, will continue to play a significant role in network troubleshooting, monitoring, and performance optimization for years to come. To help protect our customers' investment in these products, we remain committed to enhancing them with new features and capabilities such as support of FDDI (Fiber Distributed Data Interface) and new hardware platforms. At the same time, the growth of large, geographically dispersed networks has created the need for a new class of distributed analysis and monitoring products. Anticipating this trend, we applied the core Sniffer technology to a systems-level platform and created the Distributed Sniffer System (DSS). Introduced in March, 1991, the Distributed Sniffer System exceeded our initial expectations. The Company will continue its efforts to penetrate the market of centrally managed, geographically dispersed networks. This market includes third-party service providers and corporations with interconnected LANs and WANs.

### Towards A More Intelligent Future

In September, 1991, we demonstrated technology for an Expert Sniffer Analyzer which automates the real time identification and diagnosis of network problems. It was hailed in the press and by industry analysts as a revolutionary technology that will profoundly impact network management. Compared with today's network analyzers, the Expert Sniffer Analyzer is designed to give the network manager the benefit of years of accumulated knowledge about network problem solving. This technology may open the door for a much larger number of network managers to use highly sophisticated network management tools, allowing them to attack complex problems with far less training and expertise. In the same way that seven-layer analysis set the standard for network troubleshooting for the last five years, Expert Sniffer analysis may break new ground in managing network performance and problem solving. Expert Sniffer analysis is truly the next-generation technology for network management.

## A Shift In Domestic Sales Strategy

In fiscal 1992, the Company shifted its domestic sales strategy from utilizing manufacturers' representative organizations to building a direct sales force. Over the last year, we doubled the number of Network General sales offices from 15 to 30, while the headcount of domestic sales employees has increased from 54 to 90. By absorbing many of our best outside sales organizations, we have managed a smooth transition from indirect to direct sales, while retaining an experienced, well-trained sales force that can effectively sell our products.

As sales of Distributed Sniffer Systems become a larger part of our overall revenue, the need for a highly focused sales staff grows. Selling systems-level products such as DSS differs significantly from selling tools like the Sniffer Network Analyzer. Our sales force must reach a higher-level audience within the corporate structure. We believe our direct sales force can penetrate these decision-making levels more effectively than representative organizations.

## Expanding Globally

Expanding the international market for our products was a high priority this year, and we believe that our success is evidence of this. Japan and Canada are respectively our second and third largest markets outside the U.S., and we have made great strides in increasing Network General's visibility in these countries. Network General training programs, seminars, and local sales support offices are all part of this strategy. In fiscal 1992, international sales grew by 33% and totaled 25% of revenues. Yet the opportunity to do more remains, and our penetration of new markets is one of Network General's goals for fiscal 1993.

## Continuing Success

Our outstanding results in fiscal 1992 reflect Network General's success in anticipating market opportunities and providing products that meet customer needs. Our strong financial position significantly enhances our ability to respond as these opportunities arise. As shareholders, you have given us substantial support, and we appreciate your continuing confidence in Network General.

As we end fiscal 1992, our thanks go out to our employees and to our loyal customers who make Network General's success possible. We look forward with great excitement to the coming year and to meeting the challenges that lie ahead.

Harry J. Saal

**CEO, President & Chairman of the Board**

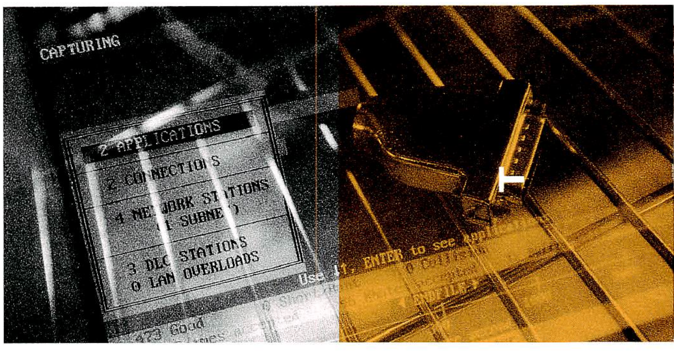
Network General was founded on the simple premise that network managers need to avoid or solve problems on local area networks (LANs). Our primary mission today is to help make the network manager's job easier by providing them with tools and systems for managing all major types of networks. —The first Sniffer Network Analyzer was designed to help people troubleshoot IBM Token Ring LANs, for which no tools were available at that time. The founders envisioned that the Sniffer Network Analyzer would expand over time to address broader problems on different kinds of networks. The Company has spent the last six years extending the Sniffer product line. We would like to share that story with you.

## The Need For A Sniffer Network Analyzer

In the early eighties, local area networks emerged as an inexpensive and simple way to connect computers. The lack of tools and systems necessary to manage networks was no obstacle to the widespread enthusiasm for this new technology. While organizations installed LANs, they also tended to move away from purchasing proprietary systems. The rapid deployment of networks and the promise of interoperability and open systems combined to encourage this new trend of purchasing multi-vendor equipment. —Problems with networks and interoperability emerged immediately. Existing management and troubleshooting tools were still proprietary and did not work across different systems. When vendors were confronted with interoperability problems they "finger pointed" instead of providing solutions. For Network General this situation created an opportunity.

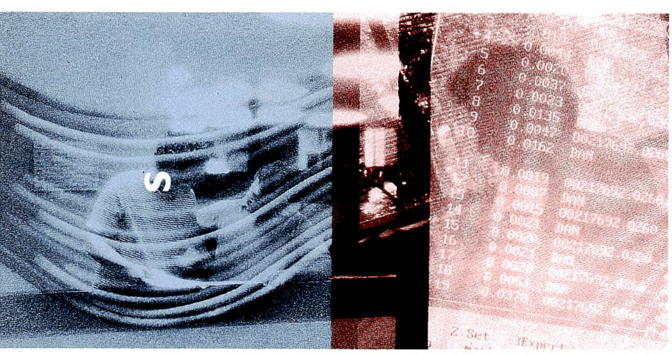
## An "X-ray" Machine For Networks

By 1986, protocol analyzers on the market decoded only the first four layers of the seven protocol layers needed to operate a network. In spite of their limitations, these early analyzers aided network managers in better guessing what was happening inside their networks. In that year, Network General introduced the Sniffer Network Analyzer for




4 Mbps Token Ring networks. Hailed as revolutionary, it provided the first comprehensive English translation of LAN protocol information. —For the first time, managers and developers could easily see what was happening inside their networks. They got interpreted information instead of raw data. The Sniffer Network Analyzer acted like an "X-ray" machine for networks, peering into the heart of each network segment to help solve problems that slow or shutdown operations. Solving these problems not only reduced network downtime but also improved worker productivity. —The Sniffer

Network Analyzer also set new standards in ease-of-use and openness. Network General created a unique, synchronized, multi-window interface for the Sniffer Network Analyzer which helped make users immediately comfortable with the tool. The Sniffer Network Analyzer was designed to run on industry-standard PCs, rather than expensive proprietary hardware. Users could take a Sniffer Network Analyzer right out of its box and begin using it to identify problems at once. Both of these early design decisions significantly reduced the amount of training required for the Sniffer Network Analyzer and contributed to its early popularity.



## Building Around The Core Technology

Today, the expanded line of Sniffer products connect more physical network topologies and interpret more protocols than any other analyzers on the market. Over the last six years, Network General has developed interfaces to eight local and wide area topologies and interpreters for over one hundred and forty protocols. The Sniffer analyzer provides a comprehensive troubleshooting and monitoring solution for managers of multi-topology, multi-protocol, multi-vendor networks. This capability underscores the Company's continuing commitment to offer users the most comprehensive LAN topology support in the network analysis industry. As new network technologies are adopted in the marketplace, Network General responds by providing its customers with appropriate solutions. Recently, the widespread installation of FDDI (Fiber Distributed Data Interface) as a backbone in large networks has become a major market factor. In response, Network General recently demonstrated the technology for an FDDI Sniffer Analyzer which is expected to ship in the summer of 1992. It will provide full seven-layer analysis to solve interoperability problems peculiar to FDDI implementations, helping organizations to realize the full benefit of these costly investments.

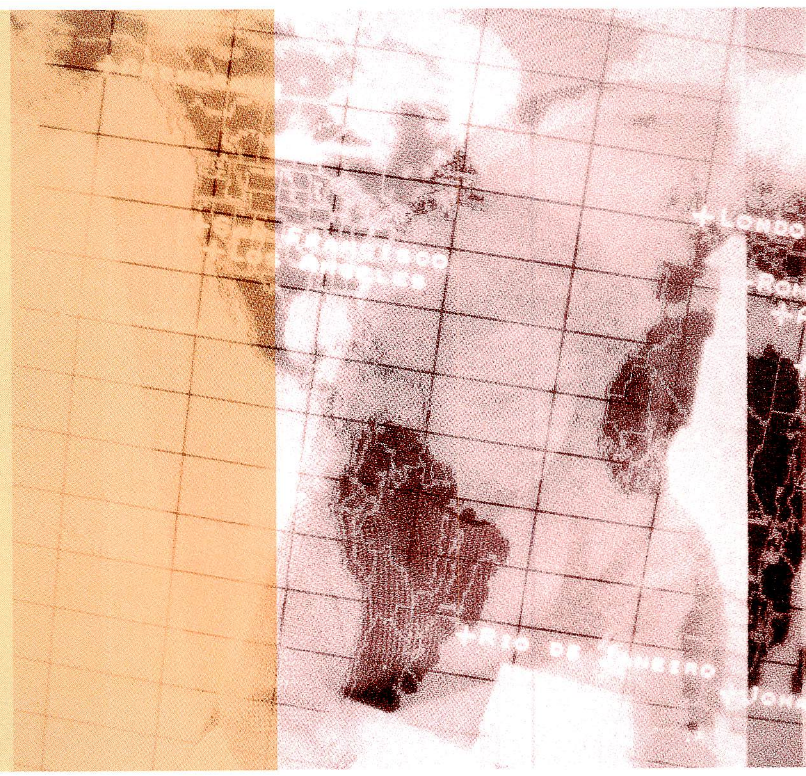
## Connecting WANs And LANs

The growth of connections between local area networks over wide area links has spawned a whole new set of problems for network managers. Many LAN applications and protocols are designed with the assumption that network bandwidth is free. Unlike LANs, leased WAN line costs are ongoing and expensive. Consequently, the cost of sending inefficient LAN application data over wide area networks can be staggering. Network General's Sniffer WAN Analyzer, introduced in September, 1990, provides a comprehensive diagnostic tool with a consistent user interface across both LAN and WAN environments. The Sniffer WAN Ana-

lyzer identifies unnecessary traffic caused by inefficient network protocols and applications. With this information, users can take steps to dramatically reduce line traffic that consumes costly bandwidth. — Many organizations assume they need a faster line when application performance degrades on their WANs or bandwidth becomes saturated. However, by identifying inefficient use of existing facilities with the Sniffer WAN Analyzer, they can reduce the need to upgrade to more expensive, faster lines or to add additional lines, potentially saving thousands of dollars a month.

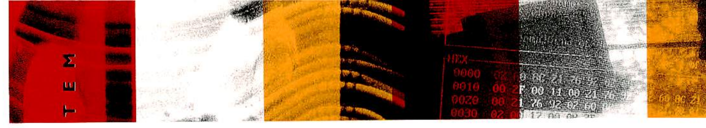
## — Telecommunications Troubleshooting With Progressive Computing

Not all WANs have LAN-related problems or are even connected to LANs. WANs associated with the telecommunications industry, utilizing technologies such as SDLC, T1, X.25, Signaling System 7 (SS7) and Integrated Services Digital Network (ISDN), also require sophisticated, easy-to-use, troubleshooting and performance monitoring tools. Tens of thousands of customers are dependent on these networks, as evidenced by recent telephone outages across the country which cost millions of dollars in lost business alone. The fiscal 1992 acquisition of Progressive Computing gives Network General a broad product line of latest generation, PC-based telecommunications testing equipment, and provides an entry into this significant marketplace. — Recent product releases from Progressive Computing include the industry's first zero-slot, PC-based WAN protocol analyzer. The LM1 PocketScope is a multi-featured analyzer that plugs into virtually any notebook or laptop PC and frees users from hauling a separate PC or protocol analyzer to customer sites. Smaller and lighter than a telephone handpiece, the LM1 PocketScope's portability allows network technicians to more easily perform analysis at any location. — The LM1 PocketScope is only



"ON MY NETWORK I CAN COLLECT 35,000 PACKETS IN 40 SECONDS. I CAN'T POSSIBLY LOOK THROUGH ALL THOSE PACKETS — EACH OF THEM CONTAINS A WHOLE LOT OF INFORMATION — IN 40 SECONDS. THE EXPERT SNIFFER CAN FIND THE PROBLEM IN THAT TIME."

– Ron Tipton University of Tennessee, in PC Week, May 4, 1992





one example of the innovative engineering that is the hallmark of Progressive Computing's product line. The future integration of Network General's Sniffer technology with Progressive Computing's product line provides the potential for creating the best possible choice of enterprise-wide network troubleshooting products for our customers. For example, a consistent user interface across LANs, WANs and internetworking technologies will help the Company create products that are easier to learn, reducing the need for expensive training and increasing user productivity.

### Distributing Sniffer Technology

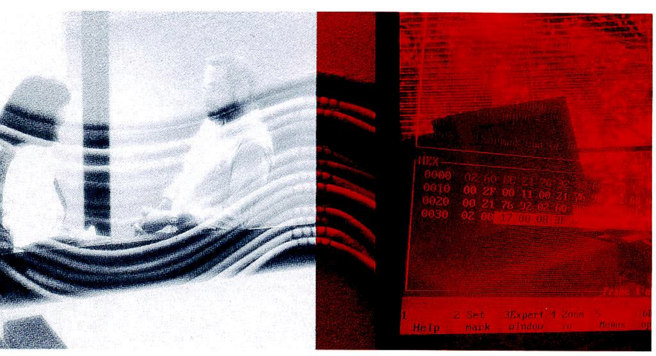
Starting with the premise that centralized problem-solving saves time and leverages the scarcity of network management expertise, Network General introduced the Distributed Sniffer System (DSS) in March, 1991. This system is the first intelligent client-server analysis solution that both monitors and analyzes Ethernet and Token Ring local area networks, as well as wide area networks. When deployed throughout the network, the system enables network managers to efficiently diagnose the problems of complex, geographically dispersed networks from centralized locations. DSS uses a client-server approach to enterprise network analysis in which distributed Sniffer Servers collect, analyze, and process information about individual network segments to which they are attached. They then communicate that information back to centrally located SniffMaster Consoles. By consolidating and displaying fully processed information from dispersed Sniffer Servers on the central Console, DSS goes beyond the simple but traffic-heavy "probe" concept of sending unprocessed data to a central location, and dramatically reduces the amount of network traffic generated by the network analysis process itself. This client-server approach also allows network managers to perform powerful analysis on multiple segments simultaneously. Since Sniffer Servers can communicate with more than one Console, the system offers a unique capability for any number of network managers to view network activity concurrently. This allows for cooperative troubleshooting when needed, and saves significant amounts of troubleshooting time by leveraging the expertise of network managers across the network. Managers can also use the system to plan the configuration of networks for maximum effectiveness, such as in the placement of bridges and routers. By providing complete seven-layer analysis and monitoring, and communicating with industry standard SNMP-based managers, DSS is vendor independent and supplementary to existing cable, hub, bridge/router, and umbrella management systems.

## A Smarter Sniffer

In September, 1991, Network General again revolutionized network protocol analysis with the announcement of Expert Sniffer technology which began shipping in April, 1992. This technology takes a leap forward in network troubleshooting by addressing several issues which currently face organizations implementing complex networks: huge amounts of data flowing through the network; a lack of intelligent tools to manage the network; limited numbers of trained network managers; and insufficient time to deal effectively with network problems.

"WE HAVE A LARGE HETEROGENEOUS NETWORK WITH ALL KINDS OF PROTOCOLS. WE'RE REALLY NOT EXPERT ON ALL THOSE PROTOCOLS, AND THE NEW EXPERT SNIFFER WILL MAKE IT EASIER TO DECODE ALL THOSE PACKETS."

– Richard Jensen Dept. of Interior Geological Survey, in PC Week, April 27, 1992

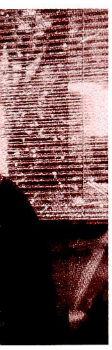


Expert Sniffer technology attacks these problems head-on by automatically identifying network problems and their causes in real time. Expert Sniffer technology incorporates the extensive knowledge and expertise that Network General has accumulated from years of working closely with customers on their network problems and performance issues. This software-based, built-in experience provides a sophisticated troubleshooting and diagnostic tool for those network managers who may not have in-depth protocol knowledge, and enhances the effectiveness of more experienced network managers. The Expert technology is integrated into Network General's current Sniffer Network Analyzer product line, and will be part of our Distributed Sniffer System within the year. A software upgrade program to incorporate the new capabilities in existing Sniffer analyzers is available to customers, thereby protecting their investment in Network General products.

## Sniffer Support Services

As a company, our goal is to help our customers solve their network problems. As a service organization, our goal is to offer comprehensive and flexible support options which allow our customers to better manage the complexity of their networks. Network General offers a wide range of professional services helping our customers use our

products to more effectively manage their networks. These services include product support, training, and network troubleshooting and consulting services. Training services provide a comprehensive network troubleshooting curriculum to enable customers to understand and effectively use our products in managing complex multi-vendor networks. Currently we offer courses at Network General headquarters in Menlo Park, California, as well as at other cities across the U.S., Europe and Asia, and at customer sites. These hands-on courses enhance the individual contribution a network support staff can make to the organizational success within diverse network environments. Network troubleshooting and consulting services give users access to the resources needed to characterize their networks and to solve the most challenging of network problems. These services provide our customers with a "safety net" for their network service personnel should they run into problems where Network General's technical expertise is required.



## A Strategy For The Future

Network General's focus is on solving network problems that span all the principal physical connection technologies and communications protocols. As a result, Network General does not favor any specific network technology over another and aims to manage all networks equally. The "family" approach to products gives a high priority to creating a consistent interface across all product lines. Because the Company is driven by software rather than hardware, we continue to use industry-standard platforms for our tools and systems. Overall, Network General believes products should be pragmatic and results-oriented, and ultimately provide maximum value to the customer. In the dynamic network industry —where accelerating change and increasing complexity are the norm — Network General believes it has achieved a significant competitive advantage as a result of this all-encompassing strategy.

## The Measure Of Success

We measure our success by achieving market share. Using this standard, the Sniffer analyzer is a resounding success; according to Dataquest, the Sniffer analyzer captured 48.2% of the U.S. LAN protocol analyzer market in 1991. We are proud of the success of the award-winning Sniffer technology which has served as the foundation for the Sniffer Network Analyzer, and the extensions of our product line encompassed by the Distributed Sniffer System and Expert Sniffer products. We believe that these Sniffer products, together with Progressive Computing's products, provide the basis for a very exciting future.

## FISCAL YEAR 1992

| | |
|---|---|
| June 28, 1991 | Distributed Sniffer System begins shipping |
| August 29, 1991 | Network General acquires Progressive Computing, Inc. |
| September 9, 1991 | Network General acquires Digitronix, Inc., a sales organization in the Midwest |
| September 23, 1991 | Network General demonstrates Expert Sniffer Technology and FDDI Sniffer Technology |
| September 23, 1991 | Roger C. Ferguson, Chief Operating Officer, and Dr. Howard Frank, Senior Fellow at the Wharton School of Business, are appointed to Company's board of directors |
| October 9, 1991 | Network General begins selling direct in Illinois, Indiana and Wisconsin |
| November 12, 1991 | Sniffer Network Analyzer product line is expanded with new low and high-end platform offerings |
| November 18, 1991 | Network General begins selling direct in the Southwest and Rocky Mountain regions |
| January 6, 1992 | Network General begins selling direct in the West Coast region |
| January 14, 1992 | LM1 PocketScope, a zero-slot, PC-based protocol analyzer is introduced |
| January 14, 1992 | ISDN tel/scope 8.1 is released |
| January 31, 1992 | Network General announces intent to file for follow-on stock offering |
| February 5, 1992 | Distributed Sniffer System with Novell IPX and paging support released |
| February 24, 1992 | NCR signs Network Services Provider agreement with Network General |

### Acquisition

In August 1991, the Company acquired all of the outstanding shares of common stock of Progressive Computing, Inc. ("PCI") in exchange for approximately 900,000 shares of the Company's common stock. The Company also assumed PCI's outstanding stock options. The merger was accounted for as a pooling of interests and, accordingly, the financial statements for prior periods have been restated to include the results of PCI. See Note 2 to Notes to Consolidated Financial Statements.

### Revenues

| | 1992 | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Revenues | **$ 63,985** | 32% | $ 48,438 | 53% | $ 31,593 |
| Gross Profit | **50,808** | 34% | 37,929 | 59% | 23,812 |
| Percentage of revenues | **79%** | | 78% | | 75% |
| Operating Expenses | **38,492** | 38% | 27,954 | 78% | 15,675 |
| Percentage of revenues | **60%** | | 58% | | 50% |
| Net Income | **8,987** | 14% | 7,850 | 34% | 5,855 |
| Earnings per share | **0.56** | 10% | 0.51 | 24% | 0.41 |

Revenues for the fiscal year ended March 31, 1992 were $64.0 million, an increase of 32% over the $48.4 million in revenues for the fiscal year ended March 31, 1991. Fiscal 1991 revenues of $48.4 million were an increase of 53% over the $31.6 million in revenues for the fiscal year ended March 31, 1990. Both domestic and international revenues increased for fiscal 1992 when compared to fiscal 1991, and for fiscal 1991 when compared to fiscal 1990. International revenues increased by 33% for the year ended March 31, 1992 compared to the year ended March 31, 1991, growing from $11.8 million to $15.7 million. International revenues increased by 87% for the year ended March 31, 1991 compared to the year ended March 31, 1990, growing from $6.3 million to $11.8 million. International revenues represented 25% of the revenues for the year ended March 31, 1992, compared to 24% for the year ended March 31, 1991 and 20% for the year ended March 31, 1990. The Company attributes the magnitude of the growth in fiscal 1992 over fiscal 1991 to a combination of factors present in fiscal 1992 as discussed below. The following table presents the Company's revenues for each of its product lines in absolute dollars and as a percentage of revenues for each of the periods shown below.

| **Sources of Revenue** | **Fiscal 1992** | Fiscal 1991 | Fiscal 1990 |
|---|---|---|---|
| Sniffer Network Analyzer Products | **$42,980** | $40,934 | $28,051 |
| Distributed Sniffer System Products | **13,039** | — | — |
| Other Revenues* | **7,966** | 7,504 | 3,542 |
| Total Revenues | **$63,985** | $48,438 | $31,593 |

| **Percentage of Revenues** | | | |
|---|---|---|---|
| Sniffer Network Analyzer Products | **67%** | 85% | 89% |
| Distributed Sniffer System Products | **20%** | — | — |
| Other Revenues* | **13%** | 15% | 11% |
| Total Revenues | **100%** | 100% | 100% |

*Other Revenues include revenues from the PCI line of Wide Area Network (WAN) analysis products, the Watchdog Network Monitor Products, training, software support and maintenance contracts, product rentals, consulting services and royalties from license agreements. The portion of Other Revenues relating to revenues from services (consisting of training, software support and maintenance contracts, and consulting services) constituted less than 5% of the Company's total revenues for the years ended March 31, 1992, March 31, 1991 and March 31, 1990.

The Company's Sniffer Network Analyzer revenues increased in the year ended March 31, 1992 to $43.0 million, a 5% increase over the $40.9 million in revenues for the year ended March 31, 1991. Fiscal 1991 Sniffer Network Analyzer revenues increased 46% over the $28.1 million in revenues for the year ended March 31, 1990. The increase in Sniffer Network Analyzer revenues during the 1992 fiscal year resulted primarily from an increase in export sales. A small portion of the increase is attributable to a change in the Company's domestic sales incentive and pricing strategy which was implemented in the second half of fiscal 1992, that encouraged sales of the Company's module-level versions of Sniffer Network Analyzer products domestically. There were no changes made in the Company's international pricing or in the level of discounts provided to the Company's distributors internationally.

The change in domestic sales incentive strategy consisted of higher commissions on sales of module-level versions of Sniffer Network Analyzer products. The change in domestic pricing strategy was due to the implementation of a marketing program under which the Company offered to its customers module-level versions of Sniffer Network Analyzer products with all related software options in one package at a price which was lower than would apply to the module-level version and these options if purchased separately. The Company believes that these changes contributed to the increase in both the unit sales of Sniffer Network Analyzer products and the increased proportion of module-level version sales of these products (relative to platform-based sales). Although the sales price of module-level versions of Sniffer Network Analyzer products is generally approximately $2,000 to $12,000 lower than the sales price of platform-based versions, depending upon the configuration, the increased unit volume in the second half of fiscal 1992 more than offset the decline in average sales price and contributed to the revenue increase over the prior fiscal year. The Company believes that the changes to its domestic sales incentive and pricing strategy contributed to an increase in percentage gross margin, which is further described below in the Gross Profit section.

Revenues for fiscal 1992, included $13.0 million in sales of Distributed Sniffer Systems ("DSS"). The Company began shipping DSS products in June 1991. Sales of DSS products increased rapidly to $4.4 million in revenues for the third quarter of fiscal 1992, while fourth quarter of fiscal 1992 remained at the $4.4 million dollar revenue level. During the year ended March 31, 1992, DSS products represented approximately 20% of Network General's revenues. There can be no assurance that sales of DSS products will increase as rapidly, or at all, in the future.

Other Revenues shown in the table above include revenues from the PCI line of Wide Area Network (WAN) analysis products, the Watchdog Network Monitor products, training, software support and maintenance contracts, product rentals, consulting services and royalties from license agreements. The portion of Other Revenues relating to revenues from services (consisting of training, software support and maintenance contracts, and consulting services) constituted less than 5% of the Company's total revenues for the years ended March 31,1992, March 31,1991 and March 31,1990.

Network General typically operates with very little backlog, and most of its revenues in each quarter result from orders booked in that quarter. Further, Network General typically generates approximately one half of its revenues for each quarter in the last month of the quarter. The Company establishes its expenditure levels based on its expectations as to future revenues, and if revenue levels are below expectations this could cause expenses to be disproportionately high. Therefore, a drop in near-term demand would significantly affect revenues causing a disproportionate reduction in profits.

In December, 1991, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 91-1, "Software Revenue Recognition". The new SOP requires among other things, that the sales value of post-contract customer support which is included as part of an initial warranty period, must be deferred and amortized over the warranty period. This is the only provision of the SOP that is expected to impact the Company's previously reported earnings. The Company plans to restate previously reported earnings when it implements the new accounting rules in the first quarter of fiscal 1993. This change is expected to reduce previously reported earnings by less than $500,000 in each of fiscal 1990, 1991 and 1992.

**Gross Profit**

Costs of revenues consist of manufacturing costs, cost of services and warranty expenses. Gross profit as a percent of revenue was 79%, 78% and 75% for the years ended March 31, 1992, March 31, 1991 and March 31, 1990, respectively. Gross profit and percentage gross margin vary as a result of a number of factors, including the mix of product sales among the Sniffer Network Analyzer products and Distributed Sniffer Systems and the mix of international and domestic sales. The Company's percentage gross margin was favorably affected in the second half of the year ended March 31, 1992 due to the previously described changes made to the Company's domestic sales incentive and pricing strategy, which contributed to an increase in both the unit sales of Sniffer Network Analyzer products and the proportion of module-level version sales of these products (relative to platform-

based sales). The percentage margin on module-level versions is higher than that on platform-based versions. The improvement caused by the changes to the Company's domestic sales incentive and pricing strategy was partially offset by increased sales of DSS products, which generally have a lower percentage gross margin than Sniffer Network Analyzer products. Network General's revenues and percentage gross margin will vary to the extent the mix of products it sells changes among Sniffer Network Analyzer products and DSS products.

### Sales and Marketing Expenses

| | 1992 | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Sales and Marketing Expense | **$26,319** | 30% | $20,205 | 92% | $10,538 |
| Percentage of revenues | **41%** | | 42% | | 33% |

Sales and marketing expenses were $26.3 million in fiscal 1992, an increase of 30% compared to $20.2 million in fiscal 1991. Fiscal 1991 sales and marketing expenses increased 92% compared to the $10.5 million in fiscal 1990. As a percent of revenues, sales and marketing expenses were 41% of revenues in fiscal 1992, compared to 42% of revenues in fiscal 1991 and 33% of revenues in fiscal 1990. Sales and marketing expenses as a percentage of revenues vary as a result of changes in the mix of domestic and international sales; the Company's sales expenses have been lower internationally since it sells through distributors outside of the United States who do not receive commissions. In addition, variations occur due to the timing of promotion expenditures.

During fiscal 1992, the Company continued to expand its domestic direct sales force. In most cases, the expansion occurred through negotiated agreements with the Company's independent manufacturers' representatives which permitted the Company to hire individuals who previously represented Network General products as employees of independent manufacturers' representatives. As a result of this expansion, the Company had 90 domestic sales employees at March 31, 1992, as compared to 54 at March 31, 1991 and 28 at March 31, 1990. The expansion of the Company's domestic direct sales force has increased the fixed portion of the Company's sales and marketing expenses. This is due to the fact that manufacturers' representatives were paid solely on commission which varies with revenues, while the Company's domestic direct sales personnel receive a fixed base salary and a variable commission based on revenues. The salary expense associated with the increase in the number of sales employees is primarily responsible for the increase in the fixed portion of the Company's sales and marketing expenses. The Company's standard sales compensation plan typically provides that if these personnel meet their sales objectives, their compensation will consist of approximately equal amounts of base salary and commission. In addition, the Company will incur approximately $470,000 in incremental expenses per quarter through December 31, 1992 (and diminishing amounts thereafter over the next several years) relating to the termination of arrangements with its prior domestic manufacturers' representatives. As a result, if revenues are lower than expected, sales and marketing expenses will be disproportionately high. Therefore, lower-than-anticipated revenues would have a greater impact on operating income than prior to this shift.

### Research and Development Expenses

| | 1992 | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Research and Development Expense | **$6,474** | 59% | $4,079 | 57% | $2,605 |
| Percentage of revenues | **10%** | | 8% | | 8% |

Research and development expenses were $6.5 million in fiscal 1992, as compared to $4.1 million in fiscal 1991 and $2.6 million in fiscal 1990. The increase in fiscal 1991 when compared to fiscal 1990 was primarily due to increased staffing to support development of the Distributed Sniffer System. The increase in fiscal 1992 when compared to fiscal 1991 was primarily due to increased staffing to support development of a new release of the Company's Sniffer Network Analyzer software containing expert systems technology and a Sniffer Network Analyzer designed for FDDI (Fiber Distributed Data Interface) networks. Of these two, the costs associated with the Expert Sniffer release are substantially greater than the costs associated with the FDDI Sniffer product.

The Company began shipping the new release of Sniffer Network Analyzer software in April 1992 and expects to ship the FDDI product in the summer of 1992. While development efforts for the FDDI product are currently on schedule, there can be no assurance that this product will be developed successfully or on time or, if developed, will achieve market acceptance. The Company believes that continued commitment to research and development is required to remain competitive. Research and development expenses as a percent of revenues were 10%, 8% and 8% for the years ended March 31, 1992, 1991 and 1990, respectively.

Research and development expenses are accounted for in accordance with FASB Statement No. 86, under which the Company is required to capitalize software development costs after technological feasibility is established. Capitalizable software development costs incurred to date have not been significant and, thus, the Company has charged all software development costs to expenses in the consolidated statements of operations.

### General and Administrative Expenses

| | **1992** | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| General and Administrative Expense | **$4,383** | (1%) | $4,434 | 75% | $2,532 |
| Percentage of revenues | **7%** | | 9% | | 8% |

General and administrative expenses for the fiscal year ended March 31, 1992 were $4.4 million, approximately the same as the $4.4 million in such expenses for the fiscal year ended March 31, 1991. Fiscal 1991 general and administrative expenses increased 75% from the $2.5 million in the fiscal year ended March 31, 1990. General and administrative expenses decreased slightly in fiscal 1992 as compared to fiscal 1991 due to savings achieved through reductions in staff following the merger with Progressive Computing, Inc. The increase in expenses in fiscal 1991 when compared to fiscal 1990 was primarily due to increases in staffing. General and administrative expenses as a percent of revenues were 7%, 9% and 8% for the years ended March 31, 1992, 1991 and 1990, respectively.

### Other Operating Expenses

Other operating expenses of $1.3 million were reported in fiscal 1992, as a result of the previously mentioned acquisition of Progressive Computing, Inc. and the termination of a sales agreement with Quad Technologies. This is compared to a gain on sale of a product line by Progressive Computing, Inc., in fiscal 1991, which resulted in $764,000 of income. There were no other operating expenses in fiscal 1990.

### Interest Income

| | **1992** | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Interest Income | **$1,507** | (4%) | $1,567 | 11% | $1,408 |
| Percentage of revenues | **2%** | | 3% | | 4% |

Interest income decreased to $1.5 million in fiscal 1992 as compared to $1.6 million in fiscal 1991, but fiscal 1991 was an increase as compared to the $1.4 million of interest income earned in fiscal 1990. The decrease in fiscal 1992 as compared to fiscal 1991 is primarily due to lower interest income received from investments, reflecting the decline in interest rates in fiscal 1992 versus fiscal 1991. The increase in interest income received in fiscal 1991 as compared to fiscal 1990, is primarily due to a higher amount of cash, cash equivalents and marketable securities available for investment in fiscal 1991.

### Provision for Income Taxes

| | 1992 | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Provision for Income Tax | **$4,836** | 31% | $3,692 | — | $3,690 |
| Effective tax rate | **35%** | | 32% | | 39% |

The provision for income taxes was 35% of pretax income for the year ended March 31, 1992, as compared to 32% for the year ended March 31, 1991 and 39% for the year ended March 31, 1990. The increase in the effective tax rate for fiscal 1992 as compared to fiscal 1991 reflects the tax effect of the expenses associated with the acquisition of Progressive Computing, Inc., in the second quarter, since a portion of those expenses were not tax-deductible. The decrease in the effective tax rate in fiscal 1991 as compared to fiscal 1990 reflects the benefits derived from the Company's Foreign Sales Corporation, research and development tax credits, and investment in tax-exempt instruments.

In February 1992, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes", which supersedes SFAS 96. The Company is not required to adopt the provisions of SFAS 109 until its fiscal year 1994. The provisions of this Statement may be made, at the option of the Company, on either a retroactive or prospective basis. The Company plans to adopt the provisions of this Statement on a prospective basis in the first quarter of fiscal 1993, and believes the effect on its financial statements, upon adoption, will not be significant.

### Earnings Per Share

Earnings per share for the year ended March 31, 1992 were $0.56, an increase of 10% compared to the $0.51 per share earned in the year ended March 31, 1991. Fiscal 1991 earnings per share increased 24% compared to the $0.41 per share earned in the year ended March 31, 1990. Earnings in fiscal 1991 included income of approximately $0.03 per share relating to the sale of a product line of Progressive Computing, Inc. Earnings were reduced in fiscal 1992 by approximately $0.07 per share primarily due to costs associated with the acquisition of Progressive Computing, Inc. and, to a lesser extent, the termination of a sales agreement with Quad Technologies.

### Liquidity and Capital Resources

| | 1992 | Change | 1991 | Change | 1990 |
|---|---|---|---|---|---|
| Cash and cash equivalents | **$ 7,704** | (54%) | $ 16,907 | (22%) | $ 21,725 |
| Working Capital | **47,646** | 26% | 37,759 | 24% | 30,403 |
| Cash provided by operating activities | **7,347** | 47% | 4,995 | 11% | 4,506 |
| Cash provided by (used in) investing activities | **(19,057)** | (85%) | (10,304) | (398%) | 3,453 |
| Cash provided by financing activities | **2,507** | 411% | 491 | (96%) | 12,242 |

Net cash provided by operating activities was $7.3 million for the fiscal year ended March 31, 1992, as compared to $5.0 million for the fiscal year ended March 31, 1991 and $4.5 million for the fiscal year ended March 31, 1990. The net increase in fiscal 1992 when compared to both fiscal 1991 and to fiscal 1990 is primarily due to increases in net income, deferred revenue, accounts payable and accrued liabilities. This increase was partially offset by an increase in accounts receivable. Net accounts receivable as of March 31, 1992 were $14.2 million, an increase of $6.1 million from the $8.1 million as of March 31, 1991. The increase in net accounts receivable is primarily due to the increase in fourth quarter revenues from $12.9 million in the fourth quarter of fiscal 1991 to $19.0 million in the fourth quarter of fiscal 1992. In addition, receivables increased by approximately $1.0 million due to an increase in deferred revenue billings.

The Company had a net decrease in cash and cash equivalents of $9.2 million in fiscal 1992 as compared to a net decrease in cash and cash equivalents of $4.8 million in fiscal 1991 and a net increase in cash and cash equivalents of $20.2 million in fiscal 1990. These decreases in fiscal 1992 and fiscal 1991 were primarily due to the reinvestment of funds from investments classified as cash equivalents into marketable securities. The increase in fiscal

1990 was primarily from the proceeds of a public offering of the Company's stock. The Company used $19.1 million in cash to participate in investing activities during fiscal 1992, $14.5 million of which was due to the transfer to investments classified as marketable securities from those classified as cash equivalents. In fiscal 1991 the Company used $10.3 million in cash for investing activities, of which $8.2 million was due to the same type of transfer. Investing activities provided $3.5 million in cash in fiscal 1990, of which $6.6 million was provided by maturities of marketable security investments offset by $3.2 million in property and equipment purchases. Cash provided by financing activities was primarily due to proceeds from the exercise of employee stock options of $2.5 million in fiscal 1992 and $0.6 million in fiscal 1991. In fiscal 1990, $12.1 million was provided from the proceeds of a public offering of the Company's stock.

As of March 31, 1992, the Company's principal sources of liquidity included cash, cash investments and marketable securities of approximately $35.4 million, as compared to $30.1 million as of March 31, 1991 and $26.7 million as of March 31, 1990. The principal sources of these funds, investments and securities were the Company's two public offerings of common stock and from operations. The Company currently has no outstanding borrowings and has no established lines of credit. In April 1992, the Company completed a third public offering of its common stock at $19.50 per share. Net proceeds to the Company were approximately $46,000,000, and are to be used for general corporate purposes. The Company believes that current cash and marketable securities, together with existing sources of liquidity and anticipated funds from operations, will satisfy the Company's normal projected working capital and capital expenditure requirements for at least the next twelve months.

The Company has generated positive cash flow from operations over the past three fiscal years. During this period the Company has funded acquisitions through a combination of stock and cash. The amounts of cash used have not been significant relative to the Company's sources of short term liquidity. The Company expects that any acquisitions in the future would be made through the same methods of funding.

## SELECTED FINANCIAL DATA

### CONSOLIDATED STATEMENTS OF OPERATIONS DATA (1)

(In thousands, except per share amounts)

| | Year Ended March 31 | | | | |
|---|---|---|---|---|---|
| | **1992** | 1991 | 1990 | 1989 | 1988 |
| Revenues | **$ 63,985** | $ 48,438 | $ 31,593 | $ 14,249 | $ 5,604 |
| Income from operations | **12,316** | 9,975 | 8,137 | 4,145 | 1,502 |
| Net income | **8,987** | 7,850 | 5,855 | 2,696 | 896 |
| Earnings per share | **0.56** | 0.51 | 0.41 | 0.25 | 0.11 |
| Weighted average common and common equivalent shares outstanding | **15,926** | 15,325 | 14,409 | 10,708 | 8,370 |

### CONSOLIDATED BALANCE SHEET DATA (1)

(Dollars in thousands)

| | As of March 31 | | | | |
|---|---|---|---|---|---|
| | **1992** | 1991 | 1990 | 1989 | 1988 |
| Working capital | **$ 47,646** | $ 37,759 | $ 30,403 | $ 14,629 | $ 2,773 |
| Total assets | **64,945** | 46,926 | 37,287 | 17,360 | 4,799 |
| Long-term obligations and redeemable preferred stock | **1,026** | 222 | 232 | 247 | 2,163 |
| Total stockholders' equity | **53,362** | 41,868 | 33,217 | 15,233 | 879 |

## QUARTERLY FINANCIAL DATA (UNAUDITED) (1)

(Dollars in thousands, except per share and stock price amounts)

| | **Mar. 31, '92** | Dec. 31, '91 | Sept. 30, '91 | June 30, '91 | Mar. 31, '91 | Dec. 31, '90 | Sept. 30, '90 | June 30, '90 |
|---|---|---|---|---|---|---|---|---|
| Revenues | **$19,026** | $17,442 | $14,486 | $13,031 | $12,865 | $13,197 | $11,591 | $10,785 |
| Gross profit | **15,256** | 14,032 | 11,265 | 10,255 | 10,265 | 10,338 | 8,915 | 8,411 |
| Income from operations | **4,470** | 4,123 | 1,545 | 2,178 | 2,053 | 2,954 | 2,620 | 2,348 |
| Income before provision for income taxes | **4,808** | 4,500 | 1,949 | 2,566 | 2,449 | 3,373 | 2,980 | 2,740 |
| Net income | **3,203** | 3,016 | 1,024 | 1,744 | 1,742 | 2,264 | 2,069 | 1,775 |
| Earnings per share | **0.20** | 0.19 | 0.07 | 0.11 | 0.11 | 0.15 | 0.14 | 0.12 |
| Price range common stock | **25.50-15.63** | 17.25-12.00 | 14.38-6.75 | 9.75-7.00 | 12.25-7.00 | 9.00-5.00 | 14.50-4.25 | 13.38-11.00 |

(1) All periods reflect combined accounts for Network General and Progressive Computing, Inc. a wholly owned subsidiary of Network General acquired in August 1991, which was accounted for as a pooling of interests.

| As of March 31<br>(Dollars in thousands, except per share amounts) | 1992 | 1991 |
|---|---|---|
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | **$ 7,704** | $ 16,907 |
| Marketable securities | **27,718** | 13,200 |
| Accounts receivable, net of allowance for doubtful accounts of $445 in 1992 and $310 in 1991 | **14,244** | 8,122 |
| Inventories | **4,005** | 2,200 |
| Prepaid expenses and deposits | **4,532** | 2,166 |
| Total current assets | **58,203** | 42,595 |
| Property and Equipment, at cost: | | |
| Demonstration and rental equipment | **3,583** | 2,794 |
| Office and development equipment | **7,059** | 3,691 |
| Leasehold improvements | **500** | 380 |
| | **11,142** | 6,865 |
| Less - accumulated depreciation and amortization | **(5,185)** | (3,050) |
| Net property and equipment | **5,957** | 3,815 |
| Other Assets | **785** | 516 |
| | **$ 64,945** | $ 46,926 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current Liabilities: | | |
| Accounts payable | **$ 3,465** | $ 1,410 |
| Accrued liabilities | **4,701** | 2,534 |
| Deferred revenue | **2,391** | 892 |
| Total current liabilities | **10,557** | 4,836 |
| Long-term Obligations | **1,026** | 222 |
| Stockholders' Equity: | | |
| Preferred Stock – $.01 par value | | |
| Authorized – 2,000,000 shares | | |
| Outstanding – none | — | — |
| Common Stock – $.01 par value | | |
| Authorized – 50,000,000 shares | | |
| Outstanding – 15,615,608 shares in 1992 and 15,141,661 shares in 1991 | **156** | 151 |
| Additional paid-in-capital | **27,041** | 24,539 |
| Retained earnings | **26,165** | 17,178 |
| Total stockholders' equity | **53,362** | 41,868 |
| | **$ 64,945** | $ 46,926 |

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF OPERATIONS

| For the three years ended March 31<br>(In thousands, except per share amounts) | 1992 | 1991 | 1990 |
|---|---|---|---|
| Revenues | **$ 63,985** | $ 48,438 | $ 31,593 |
| Cost of Revenues | **13,177** | 10,509 | 7,781 |
| Gross Profit | **50,808** | 37,929 | 23,812 |
| Operating Expenses: | | | |
| Sales and marketing | **26,319** | 20,205 | 10,538 |
| Research and development | **6,474** | 4,079 | 2,605 |
| General and administrative | **4,383** | 4,434 | 2,532 |
| Gain on sale of product line | — | (764) | — |
| Other operating expenses | **1,316** | — | — |
| | **38,492** | 27,954 | 15,675 |
| Income from Operations | **12,316** | 9,975 | 8,137 |
| Interest Income | **1,507** | 1,567 | 1,408 |
| Income Before Provision for Income Taxes | **13,823** | 11,542 | 9,545 |
| Provision for Income Taxes | **4,836** | 3,692 | 3,690 |
| Net Income | **$ 8,987** | $ 7,850 | $ 5,855 |
| Earnings Per Share | **$ .56** | $ .51 | $ .41 |
| Weighted Average Common and Common Equivalent Shares Outstanding | **15,926** | 15,325 | 14,409 |

The accompanying notes are an integral part of these consolidated financial statements.

| For the three years ended March 31 (Dollars in thousands, except per share amounts) | COMMON STOCK Shares | COMMON STOCK Amount | Additional Paid-in Capital | Retained Earnings | Total |
|---|---|---|---|---|---|
| **BALANCE, MARCH 31, 1989** | 13,165,881 | $133 | $11,627 | $ 3,473 | $15,233 |
| Public Offering of common stock at $7.63 per share, net of issuance costs of $949 | 1,681,000 | 16 | 11,853 | — | 11,869 |
| Issuance of common stock under the Employee Stock Purchase Plan at $3.40 and $5.53 per share | 24,584 | — | 108 | — | 108 |
| Exercise of stock options at $4.00 per share | 3,670 | — | 15 | — | 15 |
| Issuance of common stock for services rendered, net | 41,820 | — | 134 | — | 134 |
| Repurchase of stock | (4,205) | — | (9) | — | (9) |
| Stock award vesting, net of issuance costs | 4,205 | — | 12 | — | 12 |
| Net income | — | — | — | 5,855 | 5,855 |
| **BALANCE, MARCH 31, 1990** | 14,916,955 | 149 | 23,740 | 9,328 | 33,217 |
| Issuance of common stock under the Employee Stock Purchase Plan at $6.80 and $9.14 per share | 28,680 | 1 | 222 | — | 223 |
| Exercise of stock options at $4.00-$6.38 per share | 36,972 | 1 | 155 | — | 156 |
| Conversion of notes | 131,208 | — | 170 | — | 170 |
| Repurchase of stock | (4,205) | — | (9) | — | (9) |
| Issuance of common stock for services rendered, net | 32,051 | — | 261 | — | 261 |
| Net income | — | — | — | 7,850 | 7,850 |
| **BALANCE, MARCH 31, 1991** | 15,141,661 | 151 | 24,539 | 17,178 | 41,868 |
| Issuance of common stock under the Employee Stock Purchase Plan at $7.01 per share | 56,980 | 1 | 398 | — | 399 |
| Exercise of stock options at $2.03-$8.25 per share | 416,967 | 4 | 2,104 | — | 2,108 |
| Net income | — | — | — | 8,987 | 8,987 |
| **BALANCE, MARCH 31, 1992** | **15,615,608** | **$156** | **$27,041** | **$26,165** | **$53,362** |

The accompanying notes are an integral part of these consolidated financial statements.

| For the three years ended March 31 (In thousands) | 1992 | 1991 | 1990 |
|---|---|---|---|
| **Cash Flows From Operating Activities** | | | |
| Net income | **$ 8,987** | $ 7,850 | $ 5,855 |
| Adjustments to reconcile net income to net cash provided by operating activities - | | | |
| Depreciation and amortization | **2,397** | 1,856 | 1,071 |
| Gain on sale of product line | — | (764) | — |
| Fair market value of stock awards | — | 12 | 12 |
| Deferred taxes | **180** | 222 | — |
| Provisions for doubtful accounts | **350** | 390 | 136 |
| Increase in assets | | | |
| Accounts receivable | **(6,472)** | (3,116) | (3,261) |
| Inventories | **(1,805)** | (838) | (620) |
| Prepaid expenses and deposits | **(2,366)** | (1,473) | (335) |
| Other assets | **(269)** | (257) | (169) |
| Increase (decrease) in liabilities | | | |
| Accounts payable and accrued liabilities | **3,616** | 700 | 1,733 |
| Income taxes payable | **606** | (303) | 7 |
| Deferred revenue | **2,123** | 716 | 77 |
| Net cash provided by operating activities | **7,347** | 4,995 | 4,506 |
| **Cash Flows From Investing Activities** | | | |
| (Increase) decrease in marketable securities | **(14,518)** | (8,200) | 6,551 |
| Purchase of property & equipment | **(4,539)** | (2,912) | (3,210) |
| Sale of rental equipment | — | 89 | 112 |
| Net proceeds from sale of product line | — | 827 | — |
| Purchase of product line | — | (108) | — |
| Net cash provided by (used in) investing activities | **(19,057)** | (10,304) | 3,453 |
| **Cash Flows From Financing Activities** | | | |
| Proceeds from issuance of common stock, net of issuance costs | **2,507** | 628 | 12,126 |
| Repurchase of common stock | — | (9) | (9) |
| Increase/(decrease) in short term and long term notes payable | — | (128) | 125 |
| Net cash provided by financing activities | **2,507** | 491 | 12,242 |
| Net increase (decrease) in cash and cash equivalents | **(9,203)** | (4,818) | 20,201 |
| Cash and Cash Equivalents at Beginning of Year | **16,907** | 21,725 | 1,524 |
| Cash and Cash Equivalents at End of Year | **$ 7,704** | $ 16,907 | $ 21,725 |

The accompanying notes are an integral part of these consolidated financial statements.

## 1. Operations

Network General Corporation (the "Company") designs, markets and supports software-based network analysis tools for a broad spectrum of physical connection technologies and communications protocols. The Company was incorporated in 1986 as a California corporation and changed its state of incorporation to Delaware in fiscal 1988.

## 2. Summary of Significant Accounting Policies

**Consolidation.** The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, after elimination of intercompany accounts and transactions.

**Acquisition.** In August 1991, the Company acquired all of the outstanding shares of common stock of Progressive Computing, Inc. ("PCI") in exchange for approximately 900,000 shares of the Company's common stock. The Company also assumed PCI's outstanding stock options. The merger was accounted for as a pooling of interests and, accordingly, the financial statements for prior periods have been restated to include the results of PCI.

A reconciliation of the current financial statements to previously reported separate company information is presented below (in thousands):

| Selected Statements of Operations Data | 1991 | 1990 | Three Months Ended June 30, 1991 (unaudited) | Three Months Ended June 30, 1990 (unaudited) |
|---|---|---|---|---|
| **Revenues** | | | | |
| Network General | $44,613 | $29,421 | $11,910 | $10,003 |
| PCI | 4,039 | 2,172 | 1,213 | 836 |
| Eliminations | (214) | — | (92) | (54) |
| Combined | $48,438 | $31,593 | $13,031 | $10,785 |
| **Net Income** | | | | |
| Network General | $ 7,261 | $ 5,912 | $ 1,745 | $ 1,804 |
| PCI | 589 | (57) | (1) | (29) |
| Combined | $ 7,850 | $ 5,855 | $ 1,744 | $ 1,775 |

**Revenues.** The Company recognizes product revenues upon shipment of the systems or software. Revenues on rental units under operating leases and service agreements are recognized ratably over the term of the rental or service period. Payments received in advance under such contracts are recorded as deferred revenues. Royalty income is recognized based on the number of copies of software sold by the licensees of the software products. No single customer accounted for more than 10% of revenues in fiscal 1992, 1991, or 1990. Export revenues as a percentage of revenues consist of:

| | **1992** | 1991 | 1990 |
|---|---|---|---|
| Europe | **15%** | 16% | 12% |
| Asia/Americas | **10%** | 8% | 8% |
| Total Export Revenues | **25%** | 24% | 20% |

**Cash and Cash Equivalents.** For purposes of the consolidated statements of cash flows, the Company considers certificates of deposits, commercial paper and money market funds with an original maturity date of three months or less to be cash equivalents.

**Marketable Securities.** Marketable securities have maturities greater than three months but less than one year, and are carried at the lower of cost or market. As of March 31, marketable securities consist of (in thousands):

| | **1992** | 1991 |
|---|---|---|
| Municipal notes and floaters | **$20,218** | $ 5,700 |
| Money market preferred stock | **7,500** | 7,500 |
| | **$27,718** | $13,200 |

**Inventories.** Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and related manufacturing overhead. As of March 31, inventories consist of (in thousands):

| | 1992 | 1991 |
|---|---|---|
| Purchased parts | **$2,634** | $1,452 |
| Finished goods | **1,371** | 748 |
| | **$4,005** | $2,200 |

**Property and Equipment.** Property and equipment are depreciated and/or amortized using the straight-line method over the following estimated useful lives:

| | Life |
|---|---|
| Demonstration and rental equipment | 2 years |
| Office and development equipment | 3 to 5 years |
| Leasehold improvements | Lease Term |

**Software Development Costs.** The Company anticipates capitalizing eligible computer software development costs upon the establishment of technological feasibility, which the Company has defined as completion of a working model. As of March 31, 1992, costs which were eligible for capitalization were insignificant and, thus, the Company has charged all software development costs to research and development expense in the accompanying consolidated statements of operations.

**Earnings Per Share.** Earnings per share is computed using the weighted average number of shares of common and common equivalent shares resulting from outstanding options. Fully diluted earnings per share is the same as primary earnings per share.

**Statement of Position 91-1.** In December 1991, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 91-1, "Software Revenue Recognition". The new SOP requires among other things, that the sales value of postcontract customer support which is included as part of an initial warranty period be deferred and amortized over the warranty period. This is the only provision of the SOP that is expected to impact the Company's previously reported earnings. The Company plans to restate previously reported earnings when it implements the new accounting rules in the first quarter of fiscal 1993. This change is expected to reduce previously reported earnings by less than $500,000 in each of fiscal 1990, 1991 and 1992.

## 3. Concentrations of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of marketable security investments and trade receivables. The Company has cash investment policies that limit the amount of credit exposure to any one issuer and restrict placement of these investments to issuers evaluated as credit-worthy. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising the Company's customer base, and their dispersion across many different industries and geographies.

## 4. Accrued Liabilities

As of March 31, accrued liabilities consist of the following (in thousands):

| | 1992 | 1991(1) |
|---|---|---|
| Accrued compensation and related taxes | **$1,899** | $ 825 |
| Accrued commissions | **1,614** | 811 |
| Accrued income taxes | **329** | 67 |
| Accrued sales and use taxes | **300** | 179 |
| Accrued employee stock incentive plan | **162** | 289 |
| Other accrued expenses | **397** | 363 |
| | **$4,701** | $2,534 |

(1) Certain 1991 balances are reclassified to conform with the 1992 presentation.

### 5. Commitments

The Company leased certain equipment under operating lease agreements during fiscal 1990 from a company that is wholly owned by two officers and shareholders of the Company. During fiscal 1990, the Company purchased the remainder of the equipment under lease for approximately $77,000. Payments of approximately $185,000 were paid to this leasing company in fiscal 1990.

The Company also leases its facilities and certain other equipment under noncancelable operating lease agreements. As of March 31, 1992, the minimum future lease payments under these leases are as follows (in thousands):

| Fiscal Year | |
|---|---|
| 1993 | $1,665 |
| 1994 | 1,552 |
| 1995 | 1,650 |
| 1996 | 240 |
| 1997 | 247 |
| | $5,354 |

Total rent expense was approximately $983,000, $859,000 and $400,000 in fiscal 1992, 1991 and 1990, respectively.

### 6. Employee Savings Plan

In September 1988, the Board of Directors approved an employee savings plan (the "Plan") which is intended to be qualified and exempt from tax under section 401(k) of the Internal Revenue Code. Under the Plan, employees may elect to contribute up to 15% of their gross compensation. The Company contributes to the Plan in amounts determined at the discretion of the Board of Directors. All contributions by the Company are funded currently and vest ratably over three years. All employee contributions are fully vested. Amounts provided by the Company under the plan to date have not been material.

### 7. Common Stock

In August 1990, the Company completed a two-for-one stock split effected in the form of a stock dividend. All share and per share data have been adjusted to reflect the stock split.

Subsequent to March 31, 1992, the Company completed a third public offering of its common stock in April 1992 at $19.50 per share. Proceeds to the Company were approximately $46,000,000 and are to be used for general corporate purposes.

**Stock Option Plans.** Under the Company's 1989 Employee Stock Option Plan, key employees, employee directors and consultants may be granted either incentive or non-qualified options to purchase common stock at the discretion of the Board of Directors. The Company currently has authorized a total of 2,000,000 shares for issuance under this plan. On January 24, 1992 the Board of Directors passed a resolution to increase the number of shares available for grant under the 1989 Employee Stock Option Plan by 1,500,000 shares, increasing the total authorized to 3,500,000 shares. This increase is subject to shareholders' approval. The exercise price of the stock options may not be less than the fair market value of the common stock on the date of the grant for incentive options or less than 85% of the fair market value of the common stock on the date of the grant for non-qualified options. Generally, all options either vest ratably over a three year period or in a lump sum amount at the end of three years.

Option activity under the 1989 Employee Stock Option Plan since inception is summarized as follows:

| | Available for Grant | Outstanding | Price Per Share |
|---|---|---|---|
| Initial Authorization | 500,000 | — | — |
| Granted | (172,000) | 172,000 | $ 4.00-$ 5.09 |
| Balance as of March 31, 1989 | 328,000 | 172,000 | $ 4.00-$ 5.09 |
| Authorization Increase | 1,000,000 | — | — |
| Granted | (418,800) | 418,800 | $ 5.94-$12.24 |
| Cancelled | 14,000 | (14,000) | $ 4.00-$ 5.94 |
| Exercised | — | (3,670) | $ 4.00 |
| Balance as of March 31, 1990 | 923,200 | 573,130 | $ 4.00-$12.24 |
| Authorization Increase | 500,000 | — | — |
| Granted | (1,174,510) | 1,174,510 | $ 4.00-$11.75 |
| Cancelled | 428,764 | (428,764) | $ 4.00-$12.24 |
| Exercised | — | (36,972) | $ 4.00-$ 6.38 |
| Balance as of March 31, 1991 | 677,454 | 1,281,904 | $ 4.00-$12.24 |
| Authorization Increase | 1,500,000 | — | — |
| Granted | (1,101,998) | 1,101,998 | $ 7.50-$22.75 |
| Cancelled | 218,824 | (218,824) | $ 4.00-$14.50 |
| Exercised | — | (273,802) | $ 4.00-$ 8.25 |
| Balance as of March 31, 1992 | 1,294,280 | 1,891,276 | $ 4.00-$22.75 |

Of the outstanding options, 109,320 were exercisable as of March 31, 1992.

In April 1989, the Company established the 1989 Outside Directors Stock Option Plan, whereby outside directors may be granted non-qualified options to purchase common stock. 360,000 shares of common stock were authorized for issuance under this plan. The exercise price of the stock option may not be less than the fair market value of the common stock on the date of the grant. Generally, all options vest over a three year period. Each outside director is granted an option of 60,000 shares upon election to the Board and an additional 10,000 shares each subsequent year. As of March 31, 1992, 100,000 options are available for future grant and 170,000 options are outstanding, of which, 30,000 shares were exercisable at $5.25 per share.

**Stock Purchase Plan.** The Company has authorized 300,000 shares of common stock for issuance under the 1989 Employee Stock Purchase Plan. Employees may elect to withhold up to 10% of their compensation for the purchase of the Company's common stock. The amounts withheld are used to purchase the Company's common stock at a price equal to 85% of the fair market value of the stock on the first or last day of a six-month offering period, whichever is lower. The Company issued 56,980 shares at an average price of $7.01 per share in 1992, 28,680 shares at an average price of $7.78 per share in 1991 and 24,584 shares at an average price of $4.39 per share in 1990.

**Stock Award Plan.** In June 1989, the Board of Directors approved the 1989 Common Stock Award Plan and authorized 120,000 shares for issuance thereunder. Under this plan, awards are made to independent sales representatives and consultants based upon individual sales performance criteria. The shares are issued at fair market value and the related costs of the shares are charged to sales and marketing expense over the vesting period. The shares generally vest over three years and the Company can reacquire any unvested shares upon termination of the individual's relationship with the Company. As of March 31, 1992, the number of shares that have been awarded under this plan is 29,468 shares of which 19,646 shares are vested.

**PCI Incentive Stock Options.** In August 1991, the Company acquired all of the outstanding shares of common stock of Progressive Computing, Inc. ("PCI") in exchange for approximately 900,000 shares of the Company's common stock. In connection with this acquisition, the Company assumed PCI's outstanding stock options, most of which were exchanged for stock options in the Company's 1989 Stock Option Plan. In addition, certain officers and directors of PCI were eligible for incentive stock options, which the Company also assumed. As of March 31, 1992, 32,812 incentive stock options were outstanding, all of which are fully vested and exercisable at $2.03 per share. The Company does not intend to grant any additional incentive stock options as of March 31,1992.

As of March 31, 1992 the Company has the following shares of common stock reserved for future issuance:

| | |
|---|---|
| 1989 Stock Option Plan | 3,185,556 |
| 1989 Outside Directors Stock Option Plan | 270,000 |
| 1989 Employee Stock Purchase Plan | 189,756 |
| 1989 Common Stock Award Plan | 90,532 |
| 1991 PCI Incentive Stock Options | 32,812 |
| | 3,768,656 |

## 8. Income Taxes

In February 1992, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes", which supersedes SFAS 96. The Company is not required to adopt the provisions of SFAS 109 until its fiscal year 1994. The provisions of this Statement may be made, at the option of the Company, on either a retroactive or prospective basis. The Company plans to adopt the provisions of this Statement on a prospective basis in the first quarter of fiscal 1993, and believes the effect on its financial statements, upon adoption, will not be significant. The Company paid approximately $4,408,000, $4,355,000 and $3,844,000 in income taxes in fiscal 1992, 1991 and 1990, respectively.

| | **1992** | 1991 | 1990 |
|---|---|---|---|
| Income before provision for income taxes: | | | |
| Domestic | **$13,694** | $11,454 | $ 9,545 |
| Foreign | **129** | 88 | — |
| | **$13,823** | $11,542 | $ 9,545 |
| Provision for income taxes: | | | |
| Federal | | | |
| Current payable | **$ 3,602** | $ 3,249 | $ 2,900 |
| Deferred tax asset | **(402)** | (712) | (128) |
| Non-current deferred | **542** | 236 | — |
| | **3,742** | 2,773 | 2,772 |
| State | | | |
| Current payable | **1,019** | 848 | 918 |
| Non-current deferred | **24** | 35 | — |
| | **1,043** | 883 | 918 |
| Foreign | **51** | 36 | — |
| Total Provision | **$ 4,836** | $ 3,692 | $ 3,690 |
| The sources of deferred tax assets are as follows: | | | |
| Reserves and accruals not currently deductible for tax purposes | **$ 83** | $ 319 | $ 112 |
| State taxes, not currently deductible for Federal tax purposes | **43** | 32 | 174 |
| Depreciation | **(291)** | 90 | (167) |
| Other | **1** | — | 9 |
| | **$ (164)** | $ 441 | $ 128 |

The provision for income taxes differs from the amounts obtained by applying the Federal statutory rate to income before taxes as follows:

| | | | |
|---|---|---|---|
| Statutory Federal income tax rate | **34.0%** | 34.0% | 34.0% |
| State income taxes, net of Federal benefit | **5.6** | 5.0 | 6.6 |
| Permanent differences | **(6.2)** | (7.4) | (4.7) |
| Merger and acquisition costs | **1.6** | — | — |
| Other | — | 0.4 | 2.8 |
| | **35.0%** | 32.0% | 38.7% |

## Report of Independent Public Accountants

To Network General Corporation:

We have audited the accompanying consolidated balance sheets of Network General Corporation (a Delaware corporation) and subsidiaries as of March 31, 1992 and 1991, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended March 31, 1992. These financial statements are the responsibility of Network General's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Network General Corporation and subsidiaries as of March 31, 1992 and 1991, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 1992 in conformity with generally accepted accounting principles.

Arthur Andersen & Co.

**San Jose, California**
**April 24, 1992**

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Arthur Andersen & Co.

San Jose, California
April 24, 1992

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WRITER/EDITOR: CHARLIE SCHACHTER PHOTOGRAPHY: RICK ENGLISH

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Harry J. Saal
Chairman of the Board
President and Chief
Executive Officer

Leonard J. Shustek
Executive Vice President
Secretary

Roger C. Ferguson
Vice President
Chief Operating Officer

Dr. Howard Frank
Senior Fellow
Wharton School of Business

Gregory M. Gallo
Member
Ware & Freidenrich

Laurence R. Hootnick
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Executive Officer
Maxtor Corporation

### Officers

Harry J. Saal
Chairman of the Board
President and Chief
Executive Officer
Director

Roger C. Ferguson
Vice President
Chief Operating Officer
Director

Leonard J. Shustek
Executive Vice President
Secretary and Director

Riley R. Willcox
Vice President, Finance
Chief Financial Officer

Jay Weil
Vice President, Marketing

### Legal Counsel

Ware & Freidenrich
Palo Alto, CA 94301

### Independent Public Accountants

Arthur Andersen & Co.
San Jose, CA 95110

### Inquiries Concerning Network General

If you have questions concerning Network General's operations, recent results, or historical performance, or if you wish to receive Network General's 1992 Annual Report, 1992 Form 10-K, or press releases, all of which are available without charge, please contact:

Investor Relations • Network General Corporation

4200 Bohannon Drive • Menlo Park, CA 94025 • 415/688-2700

### Inquiries Concerning The Stock

If you have any questions concerning stock certificates, change of address, consolidation of accounts, transfer of ownership, or other stock account matters, please contact Network General's stock transfer agent:

Chemical Trust Company of California

50 California Street, 10th Floor • San Francisco, CA 94111 • 800/647-4273

### Common Stock

Network General's common stock is traded on the NASDAQ National Market System under the symbol NETG. As of April 29, 1992, there were 254 stockholders of record.

### Dividend Information

Network General has never declared cash dividends and presently intends to continue this policy.

PICTURED ABOVE ARE SOME OF THE AWARDS FOR EXCELLENCE THAT NETWORK GENERAL PRODUCTS HAVE WON IN THE PAST YEAR

NETWORK GENERAL CORPORATION

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